

APPENDIX

NOTES FOR FOMC MEETING
NOVEMBER 14, 1989

SAM Y. CROSS

During the past six weeks, the dollar has traded in a relatively narrow range, with the market unwilling to take it either much higher or much lower. The strong upward pressures that we experienced during August and September have been dissipating, and the Desk has not intervened since October 12th. But the dollar's resilience on the down side has also been impressive, and good investment demand for dollar assets has continued to provide firm support throughout the period.

There were three important developments during the past six weeks which, in combination, have tended to subdue the dollar's earlier exuberance.

The first of these developments was the persistent official intervention operations after the release of the September 23 statement of the Group of Seven (G-7). The initial rounds of heavy and coordinated intervention following the G-7 meeting took the market a bit by surprise, partly in that the central banks uncharacteristically intervened both within and outside their home markets. Despite these unusual tactics, market participants remained doubtful that the central banks would keep up their coordinated dollar sales if upward pressure on the dollar were to reemerge, and in early October the dollar began turning up again in part because of this view.

In fact, we continued intervening against a rising dollar and sold another \$1,310 million (\$920 million of this against yen and \$390 million against marks) during the first 10 days of the intermeeting period. The Japanese also intervened heavily during this period, selling the amount we sold against the yen. These

operations signaled to the market the depth and persistence of official commitment to resist the dollar's rise.

A second development which reduced the dollar's appeal was a series of interest rate adjustments which sharply narrowed interest differentials favorable to the dollar. In early October, the Bundesbank increased its official interest rates by one percentage point, and this move was quickly followed by most other European countries. A week later, the Japanese raised their discount rate by one-half percentage point. Meanwhile, dollar short-term interest rates have declined by around one-half of a percentage point over the intermeeting period. These interest rate adjustments have shaved 100-150 basis points off the short-term differentials favoring the dollar, bringing the cumulative narrowing since last April to more than 350 basis points.

Volatility in the U.S. stock market and a perception of vulnerabilities in U.S. financial markets generally were a third factor lessening the market's appetite for dollars. After the 190-point decline in the Dow Jones index on October 13, the dollar fell by more than six yen and seven pfennigs in two trading days, largely on concerns that foreign investment in the United States would be deterred and that the U.S. economy might be adversely affected by further large stock market declines. These concerns, it seems, continue to be a background factor influencing market sentiment, and in recent weeks the dollar has at times seemed to follow the Dow.

Despite these three body blows, the dollar continues to receive strong support, particularly from Japanese demand for U.S. securities and fixed investments. In the past two months, there have been reports of several large Japanese acquisitions in the United States--the recent purchases of Columbia Pictures and Rockefeller

Center being among the most conspicuous examples. There also seems to have been considerable Japanese interest in the U.S. Treasuries market.

Japanese capital outflows have not affected only the dollar--the mark and other currencies have benefited as well. With Japanese interest rates having moved up later, and by less, than European rates, most European currencies have advanced significantly against the yen. But, with the Japanese economy continuing to grind out massive savings and the United States still seen as the safest, largest and most liquid of the world's financial markets, it is expected that there will continue to be a flow of Japanese investment into dollar assets.

On a separate note, the mark has benefited not only from the recent increases in interest rates there, but also from a growing sense of confidence in the German economy. One factor fostering this sense of confidence has been the inflow of skilled German immigrants from Eastern Europe. In recent days, this factor has been overshadowed by increased apprehension over the pace of change in Eastern Europe in general, and in East Germany in particular. As the political situation in East Germany deteriorated, a sense of uncertainty made market participants hesitant about the short-term situation in West Germany, even though the longer-term effects may be very beneficial for the German economy.

One currency which has not benefited as it might have from foreign investment inflows during the past six weeks is sterling. Sterling has declined significantly against the dollar, and has fallen even more sharply against the mark, with the policy dispute between the Chancellor of the Exchequer and the Prime Minister's personal economic advisor that resulted in both their resignations. The pound

has since stabilized, in part because high British interest rates make it costly to hold short sterling positions, but nervousness regarding the currency's stability persists.

Looking ahead, there continues to be a disparity between the prognostications of economists on the one hand and the attitude of institutional investors on the other. Most economic analysts contend that in volume terms the U.S. trade balance already fully reflects the benefits of the dollar's decline since 1985, that the price benefits of the dollar's rise in 1988 and 1989 may be wearing off, and that macro-economic trends worldwide will lead to a lower dollar. However, investors at least so far have continued to shrug off these warnings and take the view that a sharp decline in the dollar's value is unlikely. And in the event the dollar moves lower, they believe, rightly or wrongly, that they can protect themselves from undue losses through hedging and other techniques.

Mr. Chairman, I would like to ask the Committee's approval for our operations during the intermeeting period. The Desk sold \$460 million against yen and \$195 million against marks for the Federal Reserve on six trading days between October 3 and 12 to resist upward pressure on the dollar, and we sold an equal amount for the account of the Treasury. I would also like to report to the Committee that the U.S. Treasury has warehoused \$1 billion worth of German marks with the Federal Reserve, bringing the total now warehoused to \$7 billion of the \$10 billion authorized. Separately, let me bring to your attention that Mexico has repaid \$13 million of the \$168.2 million provided equally by the Federal Reserve and the ESF as part of a \$672.6 million multilateral facility.

I would also seek the Committee's approval to renew the Federal Reserve swap agreements with other central banks and the Bank

for International Settlements (BIS), all of which come up for renewal in December. Apart from recent swap drawings by Mexico, these facilities have not been drawn on for a number of years, by either the Federal Reserve or any of our counterparties, and they cannot be drawn except by reciprocal agreement at the time of a request. Nonetheless, it is important to maintain these facilities in being. I recommend extension for an additional year, without substantive change.

NOTES FOR FOMC MEETING
NOVEMBER 14, 1989

PETER D. STERNLIGHT

Domestic Desk operations began the recent period by aiming for unchanged reserve pressures, but conditions were eased in two steps during the period in recognition of a softer business situation and risks of more pronounced weakness. The easing steps, which followed Committee conference calls on October 18 and November 6, each entailed reductions of \$50 million in the expected level of seasonal and adjustment borrowing, and each was associated with expected reductions of about 1/4 percent in the range of federal funds trading. This reduced the anticipated funds rate from around 9 percent during the first half of October to about 8-3/4 percent through early November and then around 8-1/2 percent in recent days. Interspersed with these policy-related adjustments, several downward technical adjustments were made in the path level of borrowing, totalling \$200 million, roughly keeping pace with the steep decline in seasonal borrowing. In all, the path borrowing level was reduced by \$300 million--from \$550 million to \$250 million.

The first small easing move, formalized on October 18, was no surprise to the market, coming in the wake of the sharp break in stock prices on October 13. Indeed, there had been some slight expectations of an easing step even before October 13, given a sense of softening business conditions and moderating inflation. This had been reflected in a tendency for funds to trade fairly often a shade below the widely perceived 9 percent center of gravity that prevailed through September and early October. Press comment citing official views on likely System accommodation after the stock break increased expectations of a more distinct move, so the shift to an 8-3/4 percent central tendency

for funds was virtually accomplished for us, and it took hold readily in the market.

The further downshift to 8-1/2 percent, while consistent with general expectations of further easing in coming months, surprised the market as to timing--particularly as it followed closely the October employment report in early November. This report was considered a bit stronger than expected and likely if anything to push off the date of a next easing step. To accomplish this easing, the Desk somewhat oversupplied reserves following the November 6 conference call, encouraging funds to drift lower, though taking care not to act in an over-aggressive way that might have been inconsistent with the intended caution of the move. Still, within a couple of days, market participants concluded that a move had been undertaken. Again, media coverage, with purported "inside information", accented the move. Having supplied reserves fairly generously in making the move, and then learning of market factor reserve revisions, the Desk drained reserves in recent days, partly to head off a developing view that the easing move might have been greater than intended. Market participants are pretty well convinced now that funds can be expected to trade around 8-1/2 percent, though there remains an aura of expectation of some further easing in the next month or two.

Actual borrowing levels ran above path in the early part of the period, reflecting a tight wind-up to the October 4 reserve period and some fairly heavy borrowing over the long Columbus Day weekend. In the November 1 maintenance period borrowing ran a little below path while borrowing thus far in the current period has remained below path--somewhat under \$200 million as seasonal borrowing has fallen rapidly in recent weeks and adjustment credit has been light.

Desk operations during the period were complicated by debt limit considerations. A temporary debt ceiling expired on October 31 and a new ceiling was not signed into law until November 8. In that interval, the Treasury could issue no new debt, forcing the System to redeem a \$3.5 billion bill holding without the usual exchange for new bills with the Treasury. In order to beef up its cash to the maximum possible extent before the temporary limit expired, the Treasury accelerated the payment for the bills auctioned October 30 to October 31. Because of the acceleration, the System could not pay for new bills on October 31, as the November 2 bills we would normally present in payment had not matured. The Treasury also sold some cash management bills for October 31 payment. By taking payment early and maximizing their cash take, the Treasury's cash balance rose sharply on October 31 to levels well above the capacity of their commercial bank tax and loan account depositories--thus absorbing reserves as well as imposing a significant short-term financing burden on dealers, who had underwritten an unusually heavy share of the financing.

Up to that point in the intermeeting period, the Desk had been primarily in a reserve-absorbing posture, offsetting the earlier impact of foreign exchange intervention and other reserve factors by selling about \$1.5 billion of Treasury securities to foreign accounts and redeeming \$800 million of bills. Together with the forced redemption of \$3.5 billion November 2 bills, this total reduction in system holdings momentarily approached the \$6 billion intermeeting leeway limit. Beginning October 30 the Desk began buying bills from foreign accounts, acquiring about \$300 million over several days, and on November 1 the Desk bought about \$3.2 billion of bills in the market for November 2 delivery, nearly replacing the forced

redemption. On balance, outright holdings were reduced by about \$2.4 billion over the intermeeting period.

Temporary reserve transactions followed an even more checkered course over the period, responding to a variety of factors. Through October 27, the Desk was in the market more often than not to drain reserves through short-term matched sale-purchase transactions. This pattern was interrupted for a few days after the October 13 stock plunge, however, when reserves were added through some moderate-sized repurchase transactions, in part because press coverage had built up substantial market expectations of System largesse that we were reluctant to disappoint in toto. A further reason for RP accommodation then was a concern that the San Francisco earthquake might disrupt the normal activity of some major funds suppliers. After returning to temporary reserve withdrawals from October 19 to 27, the Desk again switched to arranging repurchase agreements as the debt limit ramifications caused reserve shortages and financing stringencies. Further temporary reserve injections were arranged as noted earlier, on November 6 and 7, to establish the Committee's slightly easier policy stance, while temporary withdrawals of reserves were undertaken in the last few days to head off possible over-interpretation of the System's move and deal with unexpected changes in reserve factors.

Most market interest rates declined during the intermeeting interval, responding to the mixed but preponderantly soft business news, and the System's two small easing steps. Congestion reflecting delays in debt-ceiling legislation, augmented by enlarged supply, put some upward pressure on bill rates, so that shorter bills were down only about 15 to 35 basis points over the period, considerably less than the decline in funds rates and closely related financing costs.

The congestion was most acute at the end of October when the Treasury accelerated the payment for weekly bills and stuffed in a modest cash management bill in order to pack its coffers to the maximum allowed by soon-to-expire debt limit authority. The Treasury sold its 3- and 6-month bills yesterday at average rates of 7.68 and 7.51 percent respectively, down from 7.83 and 7.92 percent just before the last Committee meeting. Part way through the period, just after the sharp jump in stock prices, bill rates had dropped much lower in a temporary flight-to-quality; with three-month bills briefly as low as 7 percent. Meantime, the Treasury raised about \$20 billion in the bill market, including a \$10 billion cash management bill auctioned last Friday. Rates on private money market instruments were down somewhat more than those on short-term Treasury issues--roughly 40-60 basis points.

One-year bills and intermediate-term Treasury coupon issues (out to about five years in maturity) were down about 50-60 basis points in yield for the period. Longer-term Treasury issues were down a more moderate 30-40 basis points--still an appreciable move for that sector of the market. It was the more noteworthy given the increased supplies in that sector. The Treasury raised about \$16 billion in coupon issues over the period, including \$10 billion from the quarterly refunding for which the final auction was held earlier this afternoon. In addition, there were sizable issues of fairly closely competitive high grade agency issues by TVA and REFCORP.

Delays and subsequent congestion of issuance probably cost the Treasury something in the very short-term area. A crude estimate might put the added cost of the bills for which payment was accelerated to October 31 at about 10 basis points or \$6 million. The delays and re-schedulings of coupon issues, while a source of great irritation, not to say disgust, to the markets, are harder to pin down

in cost terms. For a longer-term issue, of course, each added basis point has a much greater impact than in the bill area--one estimate places added costs in the current coupon refunding at about \$45 million per basis point--but it's hard to show that many basis points were added. To be sure, once the new auction schedule was finally announced after the debt limit was raised, the sense of heavy supply and curtailed when-issued trading did appear to have some upward yield impact. On the other side, the auction delays may have saved the Treasury a bit as rates were in an over-all downtrend--though of course this happenstance would be no excuse for the disruptive impact of the debt ceiling.

I referred a moment ago to the REFCORP issue. That \$4.5 billion auction of 30-year bonds went quite well at a 28 basis point spread over long Treasuries. In light to modest secondary market activity, the spread has narrowed slightly to about 25 or 26 basis points, possibly reflecting the reduction of tradable supply through stripping activity. While the market has warmed up to REFCORP as an acceptable issuer, given its strong Treasury backing, my impression is that many in the market remain skeptical about whether the currently envisaged dimensions of the thrift industry rescue program will prove adequate.

On a different front, I should mention that the declining yield trend for Treasury and other high-grade issues did not extend to the lower quality issues. At times, the pressures on "junk" bonds brought markets in those issues to a standstill, with particular problems for some issues financing leveraged buy-outs saddled with seemingly excessive demands on cash flow. In recent days, investors have returned to the buy side for what are regarded as the better quality "junk" issues, while letting other issues languish.

Right now, the market is just completing the delayed Treasury quarterly refunding, leaving some supply still to be digested. The mood in the high-grade fixed-income markets is fairly up-beat as the economy is seen as more likely to sag than be re-invigorated in the next quarter or two--probably permitting some further easing steps for policy. Few say they see recession as likely, but few totally dismiss the possibility either.

Leeway: Mr. Chairman, current projections suggest sizable reserve needs between now and the next Committee meeting on December 18-19, largely due to seasonal expansion of currency in circulation. The normal \$6 billion intermeeting leeway may be just barely adequate, but to be on the safe side I recommend a \$2 billion increase in the standard intermeeting leeway to \$8 billion.

MICHAEL J. PRELL
November 14, 1989

FOMC BRIEFING -- ECONOMIC OUTLOOK

As you know, our forecast this month bears a striking resemblance to that presented at the last meeting of the Committee. Judging by the tenor of comments made at the conference call last week, the question of the moment might be why the staff's projection hasn't changed -- more particularly, why we haven't talked more in terms of possible recession.

I might note that, for some time now, we have been indicating that growth in the economy might become quite slow by early 1990. And, indeed, we have said that, given such a basic trajectory, a quarter or two of negative numbers couldn't be ruled out. Admittedly, we indicated that this weakness probably would emerge in an environment of interest rates considerably above current levels. But we also didn't anticipate that the dollar would be as strong as it has been, giving us lower inflation this year but weaker net exports prospectively than we earlier projected.

So, recognizing that our crystal ball has proven fallible, it is appropriate to focus some attention on the "risks" that events may deviate significantly from what we've forecast. I propose to do that by running through the forecast sector by sector.

First, consumption. Consumers supply a good bit of the near-term momentum in our projection for the economy. In recent months, real income growth has been strong, sentiment indexes have remained high, and

liquid asset holdings have risen rapidly. This all bodes well for spending, apart from the payback for the third-quarter spurt in car sales.

This morning we received the advance report on retail sales for October. Total sales were down one percent, but excluding autos and building materials, there was a gain of 0.1 percent. There also were upward revisions to this sub-aggregate in August and September, providing a considerably higher jumping-off point for the current quarter. Overall, this very preliminary October reading suggests a little weaker growth this period than we had anticipated -- but with the crucial Christmas season still ahead.

New car sales for the first 10 days of November are being released this afternoon. With the caveats that full data are not in yet, and that corrections are possible, it looks like sales of domestic cars ran at about a 5.6 million unit annual rate on BEA seasonals and 6.5 million on our seasonals. Either number would suggest that sales are not up to the current assembly schedules. Those schedules point to pretty steady production, on a quarterly average basis, through the winter. The Big Three evidently have set aside sizable promotional budgets for this model year, and I think they will make a serious attempt to move sales closer to their build plans.

Of course, we should not forget that services today account for about half of consumer spending (and thus about one-third of GNP). We've built into our near-term forecast a continuation of fairly strong growth in service outlays, on the simple notion that, until income

trends and consumer sentiment weaken appreciably, there is no reason to expect a significant change in spending patterns.

What about residential construction? The drop in starts and new home sales in September did give us some pause. We are inclined to discount those numbers, but not entirely. We have lowered the path of starts in our forecast, and at a 1.38 million unit rate for the next several quarters, our projection is for only a mild pickup from the third-quarter average.

Uncertainties abound in this sector, and the fact that conditions today vary so greatly from locale to locale makes it difficult to pinpoint the aggregate trends. With interest rates on fixed-rate loans back in single digits again and in the lower part of the range for this decade, and with home sales up considerably on average in recent months, I think there is definitely an upside risk to the forecast. I get especially nervous in this regard when our forecast is weaker than that of the homebuilders' association.

But, on the other side of the ledger, there still is an overhang of supply in some parts of the country, adjustable-rate loans don't generally carry the kinds of teasers they used to, and tighter regulation -- not to mention the closing of some lending institutions -- may well have made construction credit less abundant. Whether we have appropriately balanced all these considerations, only time will tell.

In the business sector, too, there is no shortage of uncertainties. The Boeing strike is distorting the near-term numbers, but fundamentally we are projecting a decided deceleration of fixed investment, based on trends in contracts and orders and in corporate

cash flow. Apart from the fact that downturns in orders have proved transitory on several occasions in this expansion, a particular upside risk to our forecast might lie in the area of computer spending. Orders for office machines were up strongly this summer, and some analysts believe we may be on the verge of another major upswing in sales, with a new generation of incredibly powerful microcomputers and improved mainframes. Given the Commerce Department's deflators, a little computer spending goes a long way in real GNP.

On the downside, the financial strains afflicting a good many companies, the continuing overhang of commercial space, and the emerging excess capacity in some basic industries all raise the specter of a more significant contraction in investment.

As regards inventories, stock-to-sales ratios generally don't look alarming: They rarely do, until spending takes an unanticipated dip. Fortunately, neither the orders data nor other available information suggest that businesses have been basing their plans on wildly optimistic sales expectations. I suspect that if there is a downside risk at this point, it may be in manufacturing. The aggregate factory stocks-to-shipments ratio looks low, but it stopped falling a year ago; this is a bit troubling because firms have ongoing efforts to streamline operations so as to reduce inventory requirements. Moreover, incentives to hold stocks of materials have diminished this year, as availability has improved and prices have turned down, especially for metals.

We've forecast modest rates of inventory investment, but things conceivably could be weaker than we've anticipated. On the other hand,

a major liquidation doesn't seem to be in the offing, and of course, if final demands should outstrip our expectations, there would be the distinct possibility that the strengthening would be reinforced by greater inventory investment.

I shall skip over the considerable uncertainties attending the outlook for net exports, leaving that for Ted, and turn to the government sectors.

Despite the current legislative mess on the 1990 budget, I think we have a reasonable handle on the general direction of federal spending. It is fairly clear that the pace of defense procurement is trending lower, and that, despite the hiring of Census takers over the next several months, overall, the federal sector won't be a source of major impetus to aggregate demand.

The state and local sector is a somewhat murkier matter. We've forecast moderate growth of real purchases. There is a strong demand for spending in such areas as education, law enforcement, and basic infrastructure, and just how much of this demand will be translated into outlays isn't clear. The sector's budget position looks like a constraint, but there have been periods of persistent and sizable deficit when governmental units financed investment with bonds. For the very near term, perhaps one of the notable imponderables is the dimensions of the spending that will flow from the recent natural disasters; we've built in a small spurt, but I'll be interested in getting views of Presidents Black and Parry on this.

Summing up, then, we believe we've put together a forecast that balances the upside and downside risks for real activity. Obviously,

however, when your central tendency is as low as 1-1/2 percent, your standard error realistically encompasses zero or even somewhat less.

That said, one might reasonably argue that the more important divide in economic growth rates is not zero, but rather the level consistent with stability in resource utilization. As you know, we've continued to shape our projection around the premise that some increase in slack will be needed to achieve the Committee's objective of lower inflation. Since there has been no material change in our forecast in this regard, I shall not dwell on the question. Suffice it to say that the incoming CPI and PPI figures have not been more favorable overall than we had expected, and the new data on wages and total compensation give no evidence of a remission of labor cost pressures.

Let me now turn the floor over to Ted.

E.M.Truman
November 14, 1989

FOMC PRESENTATION -- INTERNATIONAL DEVELOPMENTS

As with the overall staff forecast, our outlook on the external side has not changed fundamentally from those we have presented at recent FOMC meetings. We continue to project that real growth abroad will proceed in 1990 and 1991 at a somewhat faster pace on average than growth in the United States, helping to boost the growth of our exports relative to imports.

We also continue to project that inflation in the major foreign industrial countries will decline somewhat in 1990 and 1991 under the influence of the monetary restraint we have seen to date and the currency appreciation we are projecting for the future. The result is that inflation in these countries is projected to average between one half to one percentage point less than in the United States.

We also continue to project a moderate decline of the dollar over the forecast period. In light of the depreciation of the dollar from late September to early November, we have reduced slightly our projection of the rate of decline of the dollar to reach the same endpoint as in the last forecast. Nevertheless, the dollar's course, everything else being equal, remains a source of risk and uncertainty in our forecast: A weaker dollar would produce more inflation pressures and real demand, and vice versa.

Our basic forecast is for essentially no change on balance over the next year or so in the U.S. current account position from the roughly \$115 billion at an annual rate that we are now projecting for the second half of 1989. In 1991, we are projecting a moderate improvement in the deficit, but it is expected to remain at more than \$100 billion at an annual rate. In terms of the GNP accounts, the external sector is expected to make little in the way of a statistical contribution to real growth on balance over the next few quarters, but by the end of 1990, the dollar's projected depreciation is expected to begin to boost real net exports of goods and services.

In the near term, our outlook for the external accounts is affected by an unusually large number of special factors, such as the Boeing strike, the bulge in the quantity of oil imports in the third quarter, and a bulge in agricultural shipments to the Soviet Union this quarter. We also are expecting an impact on our external accounts because of a pickup in gold shipments out of official holdings at the FRBNY. While this will not affect the GNP accounts (which exclude such transactions), it will affect Census trade reports by boosting exports but not imports. On balance, these factors will tend for the next 6-9 months to increase the difficulty of discerning underlying trends.

All that having been said, three features of our outlook deserve further comment. First, the revised July data and the August data on nominal merchandise trade

revealed primarily a rate of importation of non-oil goods that was larger than anticipated, largely consisting of consumer goods and machinery. We have considered the implications of this information and have concluded that, in part, it reflects the composition of domestic demand in the quarter that we had not fully appreciated. However, this information has also led us to trim somewhat our optimism about the future course of non-oil imports, leading us to boost somewhat the strength of such imports, *ceteris paribus*. If in fact these data are the first installment on a stronger underlying trend in imports, this suggests a downside risk to our forecast.

Second, we have received information on prices of both imports and exports in the third quarter: both were lower than we had forecast earlier. Part of our problem of interpretation and forecasting in this area relates to new procedures and data sources used by the Commerce Department. We have incorporated this information into our forecast, but since the surprise was larger on the export side, our revisions in real exports of goods and services because of this information have offset in part our revisions in the nominal balances because of the stronger non-oil imports.

Third, we have not taken account of recent events in central Europe, at least not on the scale that seems now to be developing. Without pretending to offer a complete analysis of the implications of these events for the U.S. economy, since they almost surely will involve non-economic

factors in which economists do not have a comparative advantage, I would offer three comments. First, in the very short run Bundesbank policy is likely to be constrained somewhat by the increased economic and political uncertainty; in other words, I would attach a much lower probability to a further tightening of Bundesbank policy over the next several months. Second, over the next year or so, I would expect somewhat higher German growth and inflation than is embodied in the Greenbook forecast along with higher nominal if not real interest rates. While this is not likely to be a strong enough factor to change the forecast's basic shape, it is a source of upside risk. Third, over the longer run extending beyond our forecast period, I would agree with the widespread expectations noted by Sam Cross, that these events will contribute importantly to the competitiveness of the West German economy as it draws upon an eager, expanding supply of skilled labor.

November 14, 1989

FOMC Briefing
Donald L. Kohn

The key issue facing the Committee is balancing concerns about the strength of the economy in the shorter run with the desire to make some longer-term progress against inflation. The judgments are particularly difficult since the latter is likely to involve a period of somewhat slower economic growth than we have experienced in recent years, but presumably need not entail a recession. These issues will be explored in depth at the next FOMC meeting in the context of the 5-year timetable in the Neal resolution. Today, I thought it might be useful to review the recent behavior of some of the financial variables included in your chart package to see how they reflect the easing in policy since last June and what kind of clues they may be giving for the kind of path we may be on for the economy and prices over the next year or so.

The first chart illustrates movements in the yield curve. The lower panel shows substantial declines throughout the maturity spectrum since the last meeting, except in the bill area, which was affected by short-run supply pressures. This movement suggests a general downward shift in expectations about future interest rates, likely spurred by a sense that the economy was weaker than anticipated and that the Federal Reserve might be a bit more aggressive in countering any incipient weakness. A similar pattern of roughly comparable declines in both short- and long-term rates since the peaks of late winter has resulted in only a minor change in the difference between federal funds and bond yields, the upper panel of the chart.

The curve remains slightly inverted, with some small decline expected in the federal funds rate in coming months. This decline is in the context of an essentially flat yield curve--much flatter than before the last several recessions. Expectations of little change in nominal interest rates imply that markets probably see real rates as being close to long-term equilibrium levels, so that neither real rates or inflation rates are expected to vary significantly from recent levels. The notion of stable expected inflation rates is reinforced by the long-term Treasury bond at nearly 8 percent; with equilibrium real rates probably between 3 and 4 percent, that nominal yield implies inflation staying in the 4 to 5 percent area.

Unfortunately, inflation expectations and real rates are not observable. The next chart gives a few measures of the one-year real rate using alternative measures of inflation expectations. With recent inflation having been damped, backward looking measures, such as used in the top chart, show rising real rates. Yet such survey data as we have indicate that people are looking through the last few months of data and continuing to expect inflation in the neighborhood of 4-1/2 percent over the next year. Expected inflation is down from earlier this year, however, damping to some extent the degree to which the drop in nominal rates has shown through to real rates. On balance, judging from the lower two panels, policy easing has produced some decline in real rates from early 1989, suggesting less restraint on the economy, but has left them above the low levels of late 1986 and early 1988, which were

associated with a subsequent increase in pressures on resources and potential acceleration of inflation.

The drop in real rates has been echoed most recently in the real exchange rate--the lower panel of the next chart--though on balance this rate is little changed from this spring. As a consequence, the easing of policy is likely to have less effect on aggregate demand than one associated with an appreciable dollar decline, such as in 1985 and 1986. Moreover, to the extent the very recent decline in the real value of the dollar was spurred by tighter policy abroad, its effect on demands for US goods and services will be somewhat muted as compared to a dollar decline that resulted from U.S. policy ease alone.

The behavior of stock prices, illustrated in real terms in the top panel, represents something of a mixed picture. The recent decline, along with the problems in the junk bond market, indicate a more sober outlook for earnings, perhaps reflecting a downward revision in expected growth of output and sales. Yet, stock prices have advanced substantially on balance this year, and are at a level that still would seem to imply that earnings aren't expected to collapse, and that the rate being used to discount future earnings is not excessively high.

As can be seen in the lower panel of the next chart, prices of certain commodities also dropped most recently. In particular, prices of industrial materials have fallen, suggesting a weakening in demand. The broader commodity price indices, however, have shown little net movement since this spring.

Money growth, shown in the next chart, has clearly reflected the easing of policy. M2 growth has gone from about 1-1/2 percent in the first half of the year to a projected 7-1/2 percent pace in the second half. The acceleration is largely a consequence of the turnaround in opportunity costs--from rising through the spring, to falling thereafter--which has been mirrored in a swing from rising to falling velocity. As can be seen, M2 would be expected to run around the upper end of its tentative range early in next year as velocity continued to decline under the impetus of the recent drop in interest rates. The 50 basis point policy easing undertaken since the last FOMC meeting probably added close to half a percentage point to M2 growth over 1990, with the bulk of this boost occurring in the first half of the year. M2 growth moderates thereafter as interest rates subsequently begin to move higher in the staff forecast and the more moderate pace of expansion of nominal income persists. At this time, we would project M2 growth for 1990 well within its tentative target range and moderating further in 1991.

M3 growth, the lower panel, has been damped by the shakeout in the thrift industry. Further retrenchment of thrifts, reflected in an overall shift of intermediation away from depositories, is expected to raise M3 velocity through 1991. Growth of this aggregate is expected to pick up next year, but to a little below the middle of its tentative range, and to continue to expand at a relatively modest 5 percent pace in 1991.

The next two charts examine the consistency of the recent and projected money growth paths with the slow economic growth and steady inflation outlook of the greenbook forecast. In chart 6, M2 and M3 are deflated and their growth averaged over four quarters. The tightening of policy in 1988 and 1989 along with the thrift crisis have produced declines in real money growth in 1989. Although dips in real money growth since the 1960s have been associated with recessions, the current decreases, taken together, are shorter and shallower than in previous episodes. Moreover, the rebounds shown would occur even if growth in the aggregates fell somewhat short of their projected rates for the first half of 1990.

The next chart assesses the inflation implications of recent and projected money growth through the P^* model. As can be seen in the upper panel, the strengthening of money growth as a consequence of the easier policy keeps P^* very close to P , suggesting that 7 percent M2 growth for a time is not consistent with much, if any, disinflation, given the equilibrium velocity and potential GNP assumptions of the model. The slight downward tilt to the inflation rate, seen in the lower panel, is produced by the slower M2 growth later in 1990 and 1991. In the context of the model, the current configuration of P^* close to P can be seen as the product of countercyclical monetary policy in the last two years. On the one hand, the economy is producing beyond its long-run potential, which tends to elevate P^* above P and result in accelerating inflation. On the other, efforts by the Federal Reserve to tighten policy last year to head off developing inflation pressures has

left velocity above its long-run level, holding down P^* and inflation. Within the confines of the P^* model, as well as within the staff green-book forecast, so long as the economy remains near, if not beyond, its potential, a desire to make progress on inflation allows limited scope for policy ease, additional growth in money balances, and associated velocity declines. Indeed, money growth probably is going to need to decelerate appreciably at some point if the Federal Reserve is to succeed in moving to price stability. What such a money path might involve under various assumptions and circumstances will be the subject of the presentation at the December meeting.

Let me conclude by stressing a refrain running through my earlier comments: none of these indicators can be accurately interpreted in isolation from each other or from underlying forces in the economy. Moreover, they interact in complex ways with what we do and what the markets expect us to do. Taken together, however, they do seem to show some effective easing of policy since the spring, cushioning to an extent a drop in demand for goods and services and associated financing, which is also reflected in the data. Some slowing in the economy was inevitable and desirable, given escalating pressures on limited resources in 1988. In general, the configuration of rates and prices in financial markets and the recent pace of liquidity expansion do not suggest a high risk of a recession. But neither do they seem to point to an appreciable easing of inflation pressures over the next year or so.